BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF QWEST CORPORATION'S FILING AMENDED RENEWED PRICE REGULATION PLAN	)))	DOCKET NO. T-01051B-03-0454
IN THE MATTER OF THE INVESTIGATION OF THE COST OF TELECOMMUNICATIONS ACCESS	))	DOCKET NO. T-00000D-00-0672

SURREBUTTAL TESTIMONY

OF

MICHAEL L. BROSCH

ON BEHALF OF THE STAFF OF THE ARIZONA CORPORATION COMMISSION

PUBLIC VERSION

JANUARY 12, 2005

Q. Please state your name and business address.

A. My name is Michael L. Brosch. My business address is 740 North Blue Parkway, Suite 204, Lee's Summit, Missouri 64086.

Q. By whom are you employed?

A. I am a principal in the firm Utilitech, Inc., a consulting firm engaged primarily in utility rate and regulation work. The firm's business and my responsibilities are related to special services work for utility regulatory clients. These services include rate case reviews, cost of service analyses, jurisdictional and class cost allocations, financial studies, rate design analyses and focused investigations related to utility operations and ratemaking issues.

Q. On whose behalf are you appearing in this proceeding?

A. I am appearing on behalf of the Arizona Corporation Commission Utilities Division Staff ("Staff").

Q. Are you the same Michael L. Brosch who previously submitted Direct Testimony in this Docket?

A. Yes.

Q. What is the purpose of your Surrebuttal testimony?

A. My Surrebuttal Testimony is responsive to the Rebuttal Testimony of Qwest witness Mr. Philip E. Grate on the broad topics of Qwest’s Financial Performance, Ratemaking Methods, Disallowance Standards and future Regulatory Reporting Requirements. I also respond to Mr. Grate’s specific arguments with respect to Staff’s revenue annualization adjustments C-3, C-4 and C-5, Staff’s Marketing and Advertising adjustment C-9 and the regulatory treatment of Fair Value Rate Base (Staff Schedule A and A-2). Messr’s Carver and Dunkel will respond to other revenue requirement issues addressed in Mr. Grate’s Rebuttal Testimony.

QWEST'S FINANCIAL PERFORMANCE

Q. In your Direct Testimony, you explained your view that Qwest's financial performance in Arizona will continue to support the Company's access to capital markets on reasonable terms. How does Mr. Grate characterize Qwest's financial performance in Arizona?

A. Mr. Grate states that "Qwest's financial performance in Arizona is declining. Specifically Qwest's revenues are declining more rapidly than its expenses."[1] At pages 2 through 5 of his rebuttal, Mr. Grate displays graphs showing downward trends in Arizona retail access line counts and Arizona Intrastate Operating Revenues, in contrast to more volatile Arizona Intrastate Operating Expenses that are not trending downward significantly. From this data, Mr. Grate concludes that, "A decline in revenues does not produce a corresponding decline in expenses"[2]

Q. Has Mr. Grate provided a complete view of Qwest's financial performance in Arizona?

A. No. Revenue and expense trends are important indicators of financial health, but other factors also merit consideration. Mr. Grate has omitted any graph of the very favorable trends being experienced by the Company with respect to declining Arizona rate base investment. Moreover, the single largest expense line item within Mr. Grate's Total Operating Expense Graph is Depreciation and Amortization Expense, which is declining considerably on a pro-forma basis, but is shown as a constant in his graph of historical data.

As I noted in my Direct Testimony, another primary indicator of financial health in terms of access to capital markets is the consistent generation of cash flows sufficient to cover fixed charges. The Arizona Intrastate operations of Qwest Corporation produce sufficient cash flows to fully service the allocated interest expense reasonably attributed to Arizona and internally generated cash flow is also well in excess of annual new construction expenditures made by Qwest in Arizona.

1 Grate Rebuttal, page 2, line 7.

Yet another indicator of financial performance under Price Cap Regulation is the revenue requirement that exists after several years experience under the existing Plan. Notably, Staff's calculated revenue requirement is not a large positive or negative amount, suggesting that the Company's adjusted earnings in Arizona are sufficient relative to its estimated cost of capital. A key driver of this result is the significant reduction in the rate at which capital assets are being consumed in Arizona, as evidenced by reduced depreciation accrual rates being advocated by both Qwest and Staff's witness.

Q. Please explain how Mr. Grate's Rebuttal graphs of access lines, revenues and expenses ignore another important trend that indicates improving financial performance?

A. Mr. Grate testifies at page 3 that, "Qwest has invested $6.8 billion in its Arizona network in order to be ready to provide high quality retail and wholesale telecommunications services on demand to whomever requests it." However, what Mr. Grate has neglected to disclose is the fact that Qwest has recently been experiencing declining <u>net</u> investment in Arizona because it is collecting depreciation more rapidly than it is investing in new plant. This trend is quite significant and can be observed in Qwest's Schedule E-5 within its R14-2-103 filing at line 44, which shows that Arizona Net Plant in Service on an Intrastate basis declined by $257 million in a single year 2003, which is a decline of more than 12 percent in the amount of Qwest telecommunications plant actually invested during that year.[3] As Qwest's net investment in Intrastate Plant (gross plant less accumulated depreciation) trends downward, the required return on rate base is reduced because the Company has less unrecovered capital investment in Arizona that must earn a return. Mr. Grate's graphs and conclusions are incomplete in showing high operating expense levels that include large depreciation accruals, while

2 Id, page 5, line 11.

3 Qwest Schedule E-5 indicates Intrastate Net Plant in Service of $2,097,73,000 at 12/31/2002, declining to $1,840,369 by 12/31/2003.

ignoring how those same high depreciation accruals are causing Arizona Intrastate rate base to decline significantly with each passing year.

Q. Is there also an omission in the "Arizona Retail Access Lines" graph appearing at page 3 of Mr. Grate's rebuttal?

A. The confidential graph appears to depict the shift from historically growing access line counts toward declining retail line counts starting in 2001. However, the scaling of the graph tends to visually amplify the apparent trend. Rather than an apparent massive loss of lines, the actual percentage decline is more accurately stated as the confidential figure set forth at Mr. Grate's page 2, line 12. More substantively, the complete omission of wholesale access line counts from the graph obscures the fact that Qwest is collecting considerable new and growing revenues by serving many of its departing retail customers on a wholesale basis. Qwest wholesale access lines have increased by more than [redacted] lines since early 2001, offsetting some of the retail access line declines recognized in Mr. Grate's graph. [4]

DISALLOWANCE STANDARDS

Q. At page 63 of his Rebuttal, Mr. Grate notes that almost 20 pages of his Direct Testimony were directed toward what he calls the Commission's "Disallowance Standards", and then he states, "In my opinion, some of the standards that have been employed in prior Arizona rate cases provide inadequate protection to investors under current circumstances. The disallowances that are the subject of this portion of my testimony represent ratemaking standards that provide investors inadequate protection." Do you believe the Commission must predetermine any specific "disallowance standards" so as to better protect investor interests?

A. No. I am advised by Counsel that the Commission is required to consider and weigh all relevant evidence before determining whether any specific utility-incurred costs are properly included in ratemaking proceedings. In my experience, this process does not require and is not conducive to the application of any rigid, formulistic

4 Confidential Response to Data Request UTI 11-7, Attachment A, comparing January 2001 through

standards or criteria, but instead relies upon specific facts and circumstances associated with a particular type of cost. Whenever a party challenges a particular utility expenditure, the utility is typically called upon to explain and defend the expenditure. In this proceeding, Qwest has the opportunity in its Rebuttal and through participation in the hearings to fully respond to each cost disallowance that has been proposed.

Q. According to Mr. Grate, "Arizona's ratemaking rules provide that all investments shall be presumed to have been prudently made, and such presumption may be set aside only by clear and convincing evidence that such investments were imprudent, when viewed in the light of all relevant conditions known or which in the exercise of reasonable judgment should have been known, at the time such investments were made." What is the significance of this statement by Mr. Grate and his related footnote reference to Arizona Administrative Code R14-2-103 A. 3. l.?

A. Mr. Grate appears to be applying definitions within the Commission's Rules <u>that apply to Rate Base Investments</u> with issues in the pending Docket involving ratemaking recovery of <u>operating expenses</u>, such as disputed advertising and incentive compensation expenses. The only place within Commission Rules where one can find the regulatory criteria Mr. Grate relies upon relate solely to what can be included in "Original cost rate base". Specifically, the language he quotes and the citation he provides in his Rebuttal footnote 42 points into the "Definitions" associated with the minimum filing requirements set forth in R 14-2-103 that state the following:

> h. "Original cost rate base" -- An amount consisting of the depreciated original cost, prudently invested, of the property (exclusive of contributions and/or advances in aid of construction) at the end of the test year, used or useful, plus a proper allowance for working capital and including all applicable pro forma adjustments.

August 2004 data.

l. "Prudently invested" -- Investments which under ordinary circumstances would be deemed reasonable and not dishonest or obviously wasteful. All investments shall be presumed to have been prudently made, and such presumptions may be set aside only by clear and convincing evidence that such investments were imprudent, when viewed in the light of all relevant conditions known or which in the exercise of reasonable judgment should have been known, at the time such investments were made.[5]

In contrast, <u>operating expense</u> items such as advertising, lobbying, corporate contributions and incentive compensation are not "investments" and such operating expenses have no presumption of reasonableness under Commission rules. No rate recovery criteria are set forth in Commission rules with respect to operating expenses.

Q. Is there any meaningful difference between the terms "investments" and "expenses" with regard to how one might reasonably interpret the Commission's Rules?

A. Yes. These accounting terms each have distinct meanings. "Investments" represent a specific type of expenditure that is capitalized as an asset on the books, for example as Plant in Service, that can then be included in rate base and depreciated over a defined useful life. If an expenditure is made (or a cost incurred) that does not produce a lasting benefit eligible for capitalization as part of Plant in Service or some other asset, that expenditure/cost is treated as an <u>expense</u> that is charged to income. The operating expense disallowance criteria Mr. Grate is trying to divine from Commission Rules simply does not exist, because the Rules pertain solely to how "investments" are to be evaluated for purposes of inclusion or exclusion in determining rate base.

Q. At page 64 of his Rebuttal, Mr. Grate complains that, "Staff's consultants, Utilitech, regularly advocate that discretionary expenditures be disallowed because they provide no direct tangible benefit to ratepayers. I find this disturbing because

5 http://www.azsos.gov/public_services/Title_14/14-02.htm

disallowances based on the tangible ratepayer benefit standard cannot yield just rates." Is "direct tangible benefit to ratepayers" the sole criteria used by Utilitech to determine which operating expenses should be allowed or disallowed?

A. No. Utilitech analyzes utility expenses for disallowance in many different ways, with attention given to whether the expense item in question is required to provide regulated services or can instead be viewed as discretionary, whether the Company can produce evidence of economic justification for the amounts expended, whether the expenses have been found objectionable by the regulator in previous proceedings and whether the expense produces any tangible benefits to the Company and its customers. In other words, I agree with Mr. Grate when he states that "whether a cost is reasonable must be viewed in light of the relevant facts and circumstances" (Grate Rebuttal at page 81, lines 8-9). Indeed, at pages 12 and 13 of my direct testimony, I list no fewer than six reasons why corporate image advertising should be disallowed in this Docket, in addition to the fact that the Commission has previously found such costs to be objectionable for ratemaking inclusion.

Q. At page 66 of his Rebuttal, Mr. Grate seeks to illustrate the problem that would arise from dependence upon a "tangible, direct benefit" criteria for ratemaking disallowances by stating, "A wide and abundant variety of prudent, reasonable and necessary costs incurred at the discretion of management in the operation of a regulated entity may provide no direct, tangible benefit to ratepayers. Some examples include employees' paid vacations and sick leave, employees' healthcare benefits and retirement savings plan benefits, employees' post employment benefits, and employee training expenses. Other expenses that may provide no direct tangible ratepayer benefit include the cost of compliance with immigration laws, environmental laws, safety laws, and workers' compensation laws and the costs of operating the Company's accounts receivable department, accounts payable department, customer billing department, customer credit department, legal department, tax department, human resources department, risk management department and real estate department." Has Staff sought to disallow any of these costs in this proceeding?

A. No. Staff's proposed disallowances are limited to areas where regulators often find problems with rate case recovery – such as corporate image advertising, legislative affairs and incentive compensation. The employee benefits and various department costs listed by Mr. Grate are representative of costs that <u>do</u> provide tangible, direct benefits to the Company and its ratepayers and are not discretionary to the same extent as the corporate image advertising, legislative affairs and incentive compensation costs that are being challenged by Staff.

Q. At pages 65-66 of his Rebuttal, Mr. Grate states, "There is no administrative rule of this Commission and no published judicial opinion in Arizona that imposes a presumption that discretionary costs are to be disallowed unless a utility overcomes a burden of proof to show why they should not be. Instead, the Commission's rules articulate a ratemaking principle that presumes costs are reasonable and not dishonest or obviously wasteful. Except in very limited circumstances—such as fines and penalties—the burden must fall to those parties and their representatives who would disallow a cost to provide clear and convincing evidence in support of the disallowance." How do you respond?

A. It is true that Staff is not relying upon any administrative rule or judicial opinion in support of its proposed treatment of corporate image advertising or incentive compensation and a review of Staff testimony on these issues reveals no citation to any Rule or Opinion. On the other hand, there is no Commission rule as Mr. Grate suggests that would "presume costs are reasonable" or that would impose a "clear and convincing evidence" standard upon Staff in support of proposed disallowances. In the instant case, Staff has applied ACC precedent as well as the other criteria described in its Direct Testimony to certain costs and challenged Qwest to justify the rate case inclusion of such costs. Qwest then has the opportunity and responsibility to respond to this challenge in its Rebuttal, in hearings and in briefing to support the reasonableness of rate case recovery of such costs.

Q. At page 67 of his Rebuttal, Mr. Grate states, "Utilities, like commercial businesses in general, make substantial discretionary expenditures that provide their customers no direct tangible benefit. Consequently, Utilitech must select only a handful of these kinds of expenditures and build a case against them based on policy arguments, not on a comparison to commercial business standards." Has Qwest, in its own revenue requirement filing, excluded certain discretionary costs based on policy rather than "commercial business standards"?

A. Yes. I find it remarkably inconsistent that Mr. Grate argues that any cost Qwest chooses to incur as a commercial business expense should be presumed reasonable for ratemaking purposes at the same time the Company has elected to not seek recovery of certain types of costs it must view as difficult to defend before regulators. For example, Qwest has elected to exclude discretionary test year corporate contributions and corporate sponsorship of athletic venues within its own ratemaking adjustments PFR-07 and PFN-16.[6]

To the extent Qwest sponsors a traditional revenue requirement case for consideration in this Docket, it is my opinion that the revenue requirement should be prepared using established Commission regulatory policies or that the Company bear a burden of proof to justify any proposed departure from such policies.[7]

CORPORATE "IMAGE" ADVERTISING

Q. At page 79 of his Rebuttal, Mr. Grate states his disagreement with your assertion in Direct Testimony that Qwest's test year image advertising expenses have increased in an apparent effort to enhance Qwest's reputation, credibility and image after experiencing widely publicized financial difficulties, accounting investigations and senior management turnover. Did you draw this conclusion on your own, or did Qwest's own documents support this view?

6 Rebuttal Exhibits of Philip Grate, Exhibit PEG-R5, page 4 of 6.
7 Confidential Response to Data Request UTI 11-7, Attachment A, comparing January 2001 through August 2004 data.

A. This point about corporate image remediation was one of six reasons I cited in support of the Commission's policy to exclude corporate image advertising. On this point, I relied upon several of Qwest's own documents that were quoted in my Direct Testimony in passages on pages 16 and 17 that were classified by Qwest as "highly confidential" and "confidential". Copies of the Qwest marketing documents supporting this conclusion about customer perceptions of Qwest are included in Attachment MLB-4 and Attachment MLB-5 to my Direct Testimony. Instead of responding to the substance of this concern, Mr. Grate quarrels with the way I display Arizona Advertising Costs by Category in the table at page 11 of my testimony and he claims my conclusion about increased image advertising in the test year is "misleading".

Q. Is the comparative cost table on page 11 of your Direct Testimony "misleading", as claimed by Mr. Grate?

A. No. That table shows on the first two lines the amounts of recorded advertising in the two relevant FCC Accounts, while at lines 12 through 18 my testimony explains the accounting error that caused a mis-classification of advertising that is actually "Corporate Brand Advertising". Even after correction, Corporate Brand Advertising is much larger in the 2003 test year than in 2002, as Qwest's financial difficulties, accounting investigations and senior management turnover started to be widely publicized. Brand Advertising expenses are also slightly higher in 2003 than the average expense levels for 2000 through 2002. I noted at page 12 of my Direct Testimony that, "Qwest has indicated that corporate advertising allocated from Qwest Services Corporation to QC and recorded as corporate brand advertising is actually mis-classified on the books, because much of this activity and cost should actually be considered product advertising" and that, "Staff has accepted this management representation in quantifying the proposed adjustment, even though this result is inconsistent with recorded information."

Q. Is there an error in the Table set forth on page 11 of your Direct Testimony?

A. Yes. In reviewing the Table for this testimony, it became obvious that a formula error caused year 2001 and 2002 cost information to be overstated. A corrected Table is set forth below:

Arizona Advertising Costs by Category ($000)

	2000	2001	2002	2003TY
Product Advertising	[redacted]	[redacted]	[redacted]	[redacted]
Corporate Brand Advertising	[redacted]	[redacted]	[redacted]	[redacted]
Total Advertising - AZ Share	[redacted]	[redacted]	[redacted]	[redacted]
Less: Disallowed Brand Advertising	[redacted]	[redacted]	[redacted]	[redacted]
Allowable Advertising	[redacted]	[redacted]	[redacted]	[redacted]

However, after correction, it is still obvious that both recorded and adjusted Brand Advertising amounts were larger in 2003 relative to 2002 and that a reasonable overall level of "Allowable Advertising" results after implementation of Staff's proposed adjustment.

Q. At page 82 of his Rebuttal, Mr. Grate challenges your qualifications to evaluate advertising costs for ratemaking purposes and then states, "…it is well known in the advertising profession that image advertising promotes and improves overall product awareness within an enterprise's customer base." Is this new information that justifies rate case recovery of corporate brand or image advertising?

A. No. It has always been true that increased corporate brand awareness is considered supportive of product advertising, but that does not mean that costs incurred to promote a favorable public image, rather than promoting specific regulated telephone products and services, should be fully recoverable. As I noted in my Direct Testimony at page 8, the Company eliminated corporate image advertising in its filing in the 1993 rate case when it could also be said that image advertising promotes and improves overall product awareness – this is not new information that should change the Commission's regulatory policies.

Q. In the Company's 1999 rate case filing and again in this Docket, it is argued that increased competition now justifies modification of Commission policy regarding corporate image advertising. In fact, Mr. Grate states at page 83, "Good service at reasonable prices is not enough in competitive markets. As, Ms. Nielander's affidavit explains, Qwest must maintain a visible brand/image presence to combat the competitive marketplace. This is accomplished through a combination of brand and image advertising." How do you respond?

A. As I explained in testimony, there has always been a degree of competition facing many of Qwest's regulated products and services and Staff has always been supportive of rate recovery for product specific advertising to promote regulated services. The declines in line counts and regulated revenues Mr. Grate emphasizes in his Rebuttal, at pages 2 through 6, suggest that Qwest's product and image advertising efforts and costs have been relatively ineffective at increasing or even sustaining sales of intrastate regulated products and services. Rate recovery of Qwest's product specific advertising costs under these circumstances is questionable, yet Staff has challenged only the corporate image advertising that cannot be directly related to regulated ILEC products and services.

Q. In your Direct Testimony, you state that Staff attempted to evaluate Qwest advertising in detail, to understand how costs were attributed among Qwest affiliates, but that useful information from Qwest was not readily available. Has the Company or Mr. Grate offered any studies of corporate image advertising effectiveness or analyses of costs by advertising campaign or ad message that represents economic justification for charging ratepayers for such costs?

A. No. Mr. Grate instead suggests that Staff has the burden of proof when applying long-standing Commission policies to disallow image advertising. He states at page 85, "Staff has not offered substantial evidence or expert opinion to show that

Qwest's test year image advertising expenditures were commercially unreasonable or wasteful or imprudent." To my knowledge, these standards of review that Mr. Grate would apply have not been approved by the Commission in any proceeding or Rule that I am aware of. More importantly, Mr. Grate has offered no evidence or proof of cost-effectiveness or reasonableness for the image advertising amounts he seeks to include in revenue requirements in opposition to established ratemaking policy in this State.

FAIR VALUE RATE BASE

Q. At page 133 of his Rebuttal, Mr. Grate states, "The Arizona Constitution as interpreted by Arizona case law provides that utilities in Arizona are permitted to earn their cost of capital on fair value rate base instead of historical cost rate base." Is a utility's "cost of capital" the same for application to either original cost or fair value rate base?

A. No. I am not an attorney and will not respond to Mr. Grate's legal argument, leaving the legal issue to be addressed in Staff's Brief. However, as a matter of regulatory finance, the required cost of capital is lower under fair value regulation. The total dollars of return required to adequately service the debt and equity capital invested in the business is the same under either approach, but the overall percentage rate of return required to generate these return dollars is quite different. The cost of capital and corresponding overall rate of return applicable to fair value rate base is lower than the cost of capital applicable to original cost rate base because the fair value rate base has been restated and factored up to account for the impact of inflation upon historical investment values. Since the nominal cost of capital is reflective of the time value of money which is driven largely by inflation, a lower cost of capital is required if one seeks to remove the inflation element from the cost rates.

Q. Please explain why the cost of capital is lower if applied to fair value rate base.

A. Cost of capital is an "opportunity cost" that is demanded by investors in return for their surrender of the opportunity to use their capital for alternative investments. This opportunity cost is made up of two components, the required "real" return and the "inflation" element of the return. The "real" return is the economic rent required to compensate for the use of the capital, including compensation for risk of loss or non-return of amounts invested. The "inflation" element is simply the recognition by investors that the purchasing power of money returned in the future will be less than the current purchasing power of that money today because of investor expectations of continuing inflation. The inflation element of the cost of capital explains why market interest rates tend to be higher in periods of rampant inflation and lower in periods of modest inflation.

When the cost of capital is applied to original cost rate base, which Mr. Grate refers to in his Rebuttal as "Prudently Invested Historical Cost Less Accelerated Depreciation" or ("PIHCLAD"), both the real return and the inflation element must be applied because the rate base is quantified on an historical or "original" cost basis, with no accounting for inflation that tends to cause the reproduction or replacement cost of historical assets to increase above historical cost. For this reason, Staff has applied the entire observed or nominal cost of capital to original cost rate base.

When the cost of capital is applied to Fair Value rate base, the historical original cost basis of plant investment is increased to account for inflation. Because inflation is being recognized in the investment base (rate base), double counting would result if the inflation element of the cost of capital were also recognized in determining the fair rate of return applicable to fair value rate base. To eliminate this double counting problem, Staff has adjusted the fair value rate of return downward proportionately, so as to revise the nominal cost of capital in direct relationship to the inflation levels being added to rate base.

Q. Mr. Grate also states, "Mr. Brosch and Ms. Diaz Cortez both back into a return for fair value rate base by first determining what Staff and RUCO believe the company should be allowed to earn on a PIHCLAD rate base and having established that amount of revenue requirement, calculate the rate of return on a fair value rate base necessary to achieve that same revenue requirement. This neutralizes the effect of using the fair value rate base and provides Qwest its cost of capital on its PIHCLAD rate base, not its fair value rate base." How do you respond?

A. First, I would note that Qwest has improperly assumed that its nominal weighted average cost of capital is applicable directly to either original cost or to fair value rate base without adjustment. This is simply wrong, in that Qwest investors do not require additional dollars of return on investment when the Company builds new plant in Arizona, rather than some other state where fair value is not recognized. It is also wrong because investors would be compensated twice for the inflation element of the return under Mr. Grate's approach – once through the inflation adjustment of the rate base and again through application of the inflation element of the cost of capital to that rate base.

As to the claim that Staff has "neutralized" the effect of fair value rate base, I disagree with the notion that there should be any "effect" to start with. Either method of investment valuation should yield, as an end result, an opportunity to earn a reasonable return on invested capital – no more and no less. It is <u>not</u> a given that utility rates are intended to be systematically higher in each of the states where fair value regulation is practiced. It is also not reasonable to expect that capital markets demand higher returns upon investments made in regulated utility assets in each of the states that practice fair value regulation, relative to other states. However, that is precisely the result one would observe under Mr. Grate's theory that the same percentage cost of capital is applicable to original cost as well as inflation-adjusted fair value rate base.

Q. What is the purpose of Attachment MLB-R1 to your Surrebuttal Testimony?

A. This Attachment is a revision to Staff Accounting Schedule A-2, so as to reflect a change to Staff's "Condition Percent" values for three Plant accounts, as shown on page 2 at lines 26, 28 and 32 in column F. The effect of this revision carries forward to Page 1 of 2 at line 4 captioned, "Staff Witness Dunkel RCND Study Adjustments" and increases Staff's proposed Fair Value Rate Base. The basis of this change is described in Mr. Dunkel's Surrebuttal Testimony.

YEAR END ANNUALIZATION ADJUSTMENTS

Q. At page 36 of his Rebuttal testimony, Mr. Grate states, "Qwest analyzed all significant USOA revenue and expense accounts and, using a consistently applied statistical method, annualized those accounts. Where a statistically significant factor could be identified that would be a statistically reliable indicator of year end levels Qwest calculated an adjustment tied to that indicator." Does this mean that Qwest consistently annualized each element of the income statement to coincide with the use of year-end rate base?

A. No. In fact, Mr. Grate admits on the next page that, "Qwest applied its annualization analysis methodology to every significant account including every significant operating expense account. None of its expense accounts qualified for adjustment under the methodology Qwest employed." The reality is that Qwest annualized virtually every one of the significant intrastate revenue accounts, but the Company has not annualized any of its wage or non-labor expenses at year end. It would be unreasonable to characterize the Company's filing as representing an operating income annualization at year-end, when only revenues are annualized by Mr. Grate's regression approach.

Mr. Carver has addressed this problem in his Direct Testimony and will respond to Mr. Grate's Rebuttal regarding the omitted expense annualization adjustments. My testimony on this point is limited to the revenue annualization adjustments that were made by Qwest.

Q. Is it necessary to adopt and apply a single annualization calculation methodology rigidly to each and every revenue and expense account, as Mr. Grate seems to imply at page 40 in stating, "My disagreement with adjustment C-16 is that it is not based on a methodology used consistently and uniformly. Instead, it singles out just seven EXTCs and adjusts just those seven."?

A. No. It would be impossible to analyze test year revenue and expense data and find a single mathematical algorithm that reasonably quantifies year-end operating income.

Staff's approach in this case, as in all prior Arizona rate cases, is to analyze available data to seek a reasonable annualization approach that produces reasonable results, without constraining the analysis to a particular methodology or algorithm. The differences in proposed annualized revenues between Staff and Qwest regarding Access Charge Revenues (Grate Rebuttal pages 48-50), Toll Service Revenues (Grate Rebuttal page 50) and Directory Assistance Revenues (Grate Rebuttal page 51) all have to do with Qwest's notion that one must rigidly apply the same calculation algorithm to every single account, or a reasonable annualization cannot be quantified.

Q. With respect to Access Charge Revenues, Mr. Grate is critical of your use of a "last quarter times four" methodology, stating, "There is no sound reason to prepare annualization adjustments that rely on different test period data periods based on subjective assessments. In particular, Mr. Brosch shows minutes of use for September through December in the table at Line 7 on Page 44 of his testimony and claims that the average for October through December (90,718 million) is more representative than December alone (88,196 million). He arbitrarily chooses to use October and November when minutes (and lines in service) were higher."8 Why did you select October through December data to annualize access minutes of use ("MOU")?

A. As explained in my Direct Testimony, access MOU are variable from month to month and do not exhibit the stability needed to simply multiply the last month's MOU data and regression coefficient times 12, as Qwest has proposed. I display the effects of this month to month variability in a data table at page 45 of my Direct Testimony, to show how fluctuations can significantly impact the annualized result, depending upon which month is selected. To smooth out this fluctuation, I employed the same "last quarter times four" method that has been consistently used by Staff in prior rate cases. The result is a lower test year revenue level than Qwest has proposed, to the benefit of the Company and its shareholders.

Q. At page 49, Mr. Grate is critical of the Staff method, stating, "Aside from being arbitrary, it creates a mismatch between test period revenues and volumes. The table that Mr. Brosch uses shows on its face why this proposal is unreasonable. As shown, September minutes of 84,523 million are excluded from his "average." Had he added that month to his calculation, the average would have been 89,170 million or within 1% of the value of actual December volumes." Why didn't you use the September data as suggested by Mr. Grate?

A. September was not used for several reasons. First, Staff did not want to face criticism for deviating from the "last quarter times four" methodology it has used in prior cases, expecting that Qwest would characterize such methodological departure as "arbitrary". Second, it was not obvious that September data was any more representative than other months falling outside of the fourth quarter previously used by Staff. Finally, the further away from year-end one reaches for data, the less "matched" the resulting calculation is to year-end rate base.

In past Arizona rate cases, to annualize revenues Staff has relied primarily upon a "last month times 12" approach for the revenue accounts driven by recurring monthly charges that are inherently more stable from month to month or, alternatively, upon a "last quarter times 4" approach for revenue accounts that are driven by fluctuating monthly message volumes or minutes of use. While Qwest seems to advance a new and different methodology in each of its rate case filings[9], Utilitech has found merit in analyzing the data and applying consistent approaches to annualize at year end, while testing the results for reasonableness relative to overall trends. In this Docket, Staff evaluated Mr. Grate's new regression approach and results and accepted them in certain instances where the results were reasonable, while making further adjustments if the results of Mr. Grate's new approach were not reasonable.[10]

8 Grate rebuttal, page 49.

9 See Brosch direct testimony at pages 37 and 38.

10 Staff initially rejected all of Qwest's regression calculations, until they were recalculated by Qwest to correct for the "constant price" problem, as explained at pages 39 through 41 of Brosch Direct

Q. Does Mr. Grate offer any substantive arguments in his Rebuttal to indicate why his Access, Toll or Directory Assistance Revenue annualization results are more reasonable than Staff's?

A. No. He is generally critical of Staff's selective rejection of Qwest's corrected regression calculations for certain revenue categories, stating at page 50, "Mixing this annualization approach with a different annualization approach in order to satisfy the analyst's subjective criteria is manipulative and therefore leads to distortion of the overall results of Qwest's consistently applied annualization analysis." However, Mr. Grate has failed to explain why Qwest's results should be found reasonable, given the specific problems identified at pages 48 through 51 of my Direct Testimony. I reject that premise of Mr. Grate's Rebuttal that suggests one must rigidly apply the same mathematical regression algorithm to every account without regard to the reasonableness of the outcome.

Q. Were you able to convince Qwest that its regression results must be abandoned for any particular revenue account?

A. Yes. For Qwest's Other Revenue Account 5264.7 <u>Miscellaneous Billings and Loadings,</u> Mr. Grate's regression calculations produced an annualized revenue amount of negative $990,957 with an R-squared statistic of .533 which Qwest has concluded is acceptable (above .50). This result is clearly unreasonable in light of significant positive revenues recorded monthly in this account. In response to Staff Data Request No. 7-02S1, Qwest agreed that this adjustment was "made in error" and should be reversed after Utilitech notified the Company that this result appeared inconsistent with actual revenue data in this account.[11] I mention this situation to illustrate that it is impractical to suggest that a formulistic approach to revenue or expense annualization can be applied rigidly to all elements of the income statement and produce reasonable results. Some informed judgment and critical analysis of the

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Testimony.

11 Philip Grate e-mail transmission of Qwest's response to UTI 7-02S1 dated 10/26/2004, and

results of each annualization calculation is required to ensure that known and measurable changes are properly reflected in a matched and balanced manner.

FINANCIAL REPORTING

Q. In your Direct Testimony, you recommended that the Company be required to prepare and submit financial information indicating its achieved operating income, rate base and return on investment.[12] In his Rebuttal on this point, Mr. Grate claims that Staff "…fails to explain why Qwest should be obligated to make annual filings if no review or modification of the price cap plan is pending."[13] How do you respond?

A. I believe that Intrastate earnings and revenue requirement data will continue to be useful during the term of any renewed Price Cap Plan, so that the Commission and its Staff can be mindful of the Company's ongoing earnings and approximate revenue requirement position in each calendar year. At the present time, the Annual Reports submitted by Qwest are of limited use in this regard, because such reports do not provide separated intrastate financial data prepared on a basis of accounting consistent with ratemaking principles established by the Commission.

Q. Do you agree with Mr. Grate's statement in Rebuttal that "preparing a detailed revenue requirement is burdensome and expensive"?

A. No. Mr. Grate has mischaracterized my recommendation regarding financial reporting. I am not recommending a "revenue requirement" calculation each year. The recommendation is that Qwest simply augment its annual financial reporting with a few pre-defined ratemaking adjustments. This recommendation does not include any studies supporting fair value rate base, depreciation accrual rates or cost of capital. The recommendation does not include any obligation for Qwest to audit or examine the reported annual results for the many normalizing and annualization adjustments that are required in a rate case filing. Instead, only the seven key issues

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UTI_7-02S1 Non-Confidential Attachment A Supplement 1 at row 21.

12 Brosch Direct Testimony, page 6.

13 Grate Rebuttal, page 137.

I identified in testimony need to be addressed by adjustment, so as to add perspective to reported actual data on an ACC basis of accounting.

Q. Do other Qwest state regulatory jurisdictions require such an annual report, even though no active proceedings are being processed?

A. Yes. According to the Company's response to Data Request UTI 21-24A, Qwest reports intrastate separated financial data at least annually in Colorado, Iowa, Montana, North Dakota, Oregon, South Dakota, Utah, Washington and Wyoming. In Colorado, Iowa and Washington, the Company also provides ratemaking adjustments appended to their regulatory financial reports. Each of these reports in other states is more useful that the form of report presently filed in Arizona. At the present time, Arizona does not receive any intrastate separated earnings or achieved rate of return data, either on an actual or ratemaking-adjusted basis.

Q. Is most of the data required to prepare intrastate separated financial results existent within Qwest's automated financial reporting systems?

A. Yes. The raw data used by Qwest to assemble its R14-2-103 filing in this proceeding was compiled using automated procedures to extract separated financial information from existing automated information systems. Each of the adjustments Staff would have Qwest append to its annual report is either a fixed amount (directory imputation, cash working capital) or is readily assembled from records maintained to support jurisdictional accounting differences on the Company's books. Since Staff is not recommending any analysis work to identify other potential adjustments, procedures can be developed to routinely capture, format and submit such reports in a manner similar to that used by Qwest to prepare financial reports in Iowa and Washington.

Q. Mr. Grate asserts that, "Qwest should not be yoked with the burden of preparing a revenue requirement unless there is a compelling need for one. Annual informational reporting for the convenience and edification of Staff does not rise to that level of need." How do you respond?

A. Again, Staff is not recommending that Qwest "prepare a revenue requirement". The recommendation of Staff is for Qwest to simply append seven prescribed adjustments to the Company's unadjusted, separated intrastate financial reports. Mr. Grate has conceded in his Rebuttal that, "Qwest routinely provides its unadjusted separated results of operations to regulatory commission staffs. Staff can use Qwest's standard reports to make its own revenue requirement calculations if it so chooses."[14] Unfortunately, Qwest does not provide even this "routine" and quite relevant report of its "separated results of operations" in Arizona and this information is critical to any informed review of Qwest's financial performance under Price Cap regulation. For the Company to provide this data and a few additional prescribed adjustments conforming to ACC regulatory policies and the directory imputation Settlement is not an unreasonable "burden", given the importance of the resulting reports to Staff and the Commission.

Q. Do you agree with Mr. Grate that enhanced financial reporting in Arizona, "…runs directly counter to the direction regulatory reporting requirements are headed"[15] since other states have decided to reduce or eliminate certain financial reporting requirements?

A. No. Mr. Grate offers no details regarding how annual financial reports filed by Qwest in the other 13 Qwest state regulatory jurisdictions compare with what is proposed to be filed in Arizona. His selection of only two states where reporting has been reduced does not support a conclusion that Arizona's present or proposed reporting is excessive or burdensome in contrast to the other 13 states. As noted above, most state jurisdictions now require more reporting of intrastate earnings data than does Arizona. I do not believe that an annual report of separated intrastate financial results, with a small number of prescribed ratemaking adjustments, is in any

14 Grate Rebuttal, page 138.
15 Id

way excessive or burdensome, given the importance of Qwest and its financial condition to the critical intrastate telecommunications infrastructure in the State of Arizona.

Q. Is modestly expanded financial reporting on an annual basis in Arizona likely to produce "…a competitive advantage by making Qwest bear the cost of new administrative burdens that its competitors are not also made to bear",[16] as suggested by Mr. Grate?

A. No. Mr. Grate has provided no estimate of the incremental cost to perform the modestly expanded annual financial reporting being recommended by Staff. Since the vast majority of the data being requested resides within the Company's existing financial reporting systems, I do not expect such costs to be significant enough to yield any competitive impacts upon Qwest.

Q. Does this conclude your testimony at this time?

A. Yes.

16 Id, page 139.